

Letter of Findings: 04-20100286
Use Tax
For the Years 2007 and 2008

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ISSUES

I. Use Tax - Manufacturing and Environmental Exemptions.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-5-3; IC § 6-2.5-5-4; IC § 6-8.1-5-1; IC § 6-2.5-5-30; [45 IAC 2.2-3-4](#); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-70](#); Indiana Dep't of State Revenue v. RCA Corporation, 310 N.E.2d 96 (Ind. Ct. App. 1974); Indiana Dep't of Revenue v. Cave Stone Inc., 457 N.E.2d 520 (Ind. 1983); Indiana Dep't of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); General Motors Corp. v. Indiana Dep't of Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991).

Taxpayer protests the imposition of use tax on several items, arguing that the items qualify for various sales and use tax exemptions.

II. Use Tax - Tax Rate.

Authority: IC § 6-2.5-2-2; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-3-3.

Taxpayer protests that the Department incorrectly assessed use tax on certain capital assets based on asset capitalization rate rather than the purchase date.

III. Tax Administration - Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a Delaware corporation headquartered in Indiana. Taxpayer manufactures aluminum die cast parts for the automotive industry. All tangible personal property produced by Taxpayer is sold for resale.

The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer for the years 2007 and 2008. The audit reviewed all capital asset purchases and reviewed 2008 purchases and projected an error percentage over the audit period. The Department's audit did not assess any sales tax because Taxpayer sells at wholesale. However, as a result of the audit Taxpayer was assessed additional use tax, penalty, and interest. Taxpayer protested some of the items assessed use tax. An administrative hearing was held on Taxpayer's protest and this Letter of Findings ensues. Additional information will be provided as necessary.

I. Use Tax - Manufacturing and Environmental Exemptions.

DISCUSSION

The Department assessed use tax on several capital assets Taxpayer used in the production area of Taxpayer's plant which had been purchased in unitary transactions. The Department's audit summary cites to [45 IAC 2.2-3-4](#) stating that tangible personal property purchased in Indiana, or elsewhere, in a retail transaction, and stored, used, or consumed in Indiana is subject to Indiana use tax for such property, unless the sales tax has been collected at the point of purchase. Taxpayer protests a few of these items - a dust hog system, mist collectors, and a lot traceability system - variously citing manufacturing, environmental, and safety exemptions.

In accordance with IC § 6-2.5-2-1(a), a sales tax, known as state gross retail tax, is imposed on Indiana retail transactions unless a valid exemption is applicable. IC § 6-2.5-2-1(b) states:

The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

A complementary excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction. IC § 6-2.5-3-2. An exemption from the use tax is granted for transactions when sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4. Certain other sales and use tax exemptions are offered. IC § 6-2.5 et seq.

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). The taxpayer claiming exemption has the burden of showing the terms of the exemption statute are met. General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991) aff'd 599 N.E.2d 588 (Ind. 1992) (Internal citations omitted). Additionally "[e]xemption statutes are strictly construed because an exemption releases property from the obligation of bearing its fair share of the cost of government." Id.

Taxpayer cites to several statutes and regulations in support of its protest. First, Taxpayer cites to IC § 6-2.5-5-3(b), the manufacturing equipment exemption, in support of its protest, as well as [45 IAC 2.2-5-8](#)(c) and

(d) which further elaborate the manufacturing exemption for exemption of the dust hog system, mist collectors, and the lot traceability system. Second, Taxpayer cites to [45 IAC 2.2-5-70\(a\)](#) which addresses the exemption of tangible personal property that is "predominantly used and acquired for the purpose of complying with any state, local or federal environmental quality statutes, regulations, or standards." Taxpayer argues that the "dust hog" and mist collectors are exempt under this regulation per Indiana Department of Environmental Management ("IDEM") requirements. Lastly, Taxpayer cites to an example under [45 IAC 2.2-5-8\(c\)](#) - example (2)(F) - which states that "safety clothing or equipment that is required to allow a worker to participate in the production process without injury or to prevent the contamination of the product during production." Taxpayer asserts that the mist collectors and dust hog are exempt under this regulation since they "filter the air to prevent respiratory injury and contamination of the product."

A. "Dust Hog System" and "Mist Collectors."

The Department's audit stated that the dust hog system was installed primarily for collecting fumes from Taxpayer's aluminum smelting furnaces during down-time maintenance functions, and that, along with the mist collectors, also collects and filters mist, smoke, dust, fumes, vapors, and odors from inside the general plant area. The Department's audit cited to Indiana Dep't of State Revenue v. RCA Corporation, 310 N.E.2d 96 (Ind. Ct. App. 1974). The Indiana Tax Court held in RCA that environmental control equipment, consisting of air-conditioning equipment, purchased by RCA, a colored television picture tube manufacturer, was not directly used in the direct production of color television picture tubes for manufacturing exemption purposes even though maintenance of a rigidly controlled environment was an integral and essential part of RCA's color picture tube manufacturing process. The Department's audit, therefore, concluded that the dust hog system and the mist collectors affected the environment in which production takes place, but not the direct manufacturing process, and therefore these items were not exempt.

Taxpayer cites to the manufacturing, environmental, and safety exemptions referred to above. Taxpayer describes the use of these two items inside and outside its plant as follows:

With respect to the air inside the plant, the mist collectors are used to drop the levels of oil and water mist from the air inside the building. The mist collectors are essential and integral to the direct production of automotive parts because the oil and water, if not removed from the air, would destroy these parts, making them worthless and unmarketable.

...

With respect to dust hogs within the plant, these items are used to prevent contamination of the outdoor air and to be in compliance with air quality standards established by IDEM [Indiana Department of Environmental Management]. Per IDEM, [Taxpayer] is required by law to prevent smoke and smog from emitting from the building as a result of the production process. The dust hogs and dust collectors installed in the plant satisfy this requirement. The equipment also has the added benefit of increasing the opacity within the plant and outside the plant. IDEM has set strong limitations with respect to opacity resulting from the taxpayer's production operations. Opacity limitations can be found on Page 11, Section C.3 of the IDEM Operating Permit.

In an email provided subsequent to the hearing, Taxpayer elaborated on the function of the dust hog system: With respect to the manufacturing process, the dust hogs and dust collectors capture smoke and smog that is created from introducing flux materials to the furnaces. Flux is an essential ingredient to the manufacturing process because it cleans and removes contaminants from the scrap metal and aluminum trimmings that are conveyed into the furnace. Scrap and trimmings from molding and machining parts are collected and melted with virgin materials (aluminum ingots) to create new castings. The scrap and trimmings have oils and other contaminants on the surface that if not removed, would create defective castings. By adding flux to the furnaces, the harmful contaminants are removed. Burning the flux in the furnaces creates smoke and smog that would be harmful to the environment. The dust hogs and dust collectors are located at the furnaces and are an essential and integral part of the integrated direct manufacturing of automotive parts produced for sale.

While Taxpayer refers to multiple statutes in support of its protest, the taxability of these two items for sales and use tax purposes is most clearly disposed of with the environmental exemption found at IC § 6-2.5-5-30 and [45 IAC 2.2-5-70\(a\)](#).

IC § 6-2.5-5-30, in relevant part, provides:

Sales of tangible personal property are exempt from the state gross retail tax if:

- (1) the property constitutes, is incorporated into, or is consumed in the operation of, a device, facility, or structure predominately used and acquired for the purpose of complying with any state, local, or federal environmental quality statutes, regulations or standards; and
- (2) the person acquiring the property is engaged in the business of manufacturing, processing, refining, mining, or agriculture.

Taxpayer has provided sufficient documentation, including IDEM materials which cite to the applicable regulations, to support Taxpayer's assertion that the dust hog system and the mist collectors were purchased to comply with an environmental quality standard and are exempt from sales and use tax under the "environmental

exemption" as defined in IC § 6-2.5-5-30. Therefore, the dust hog system and mist collectors are exempt.

B. "Lot Traceability System."

In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable. [45 IAC 2.2-5-8\(a\)](#).

The exemption only applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. Id. Machinery, tools, and equipment are directly used in the production process if they have an immediate effect on the article being produced. [45 IAC 2.2-5-8\(c\)](#). A machine, tool, or equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. [45 IAC 2.2-5-8\(c\)](#); Indiana Dep't of Revenue v. Cave Stone Inc., 457 N.E.2d 520 (Ind. 1983). An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." [45 IAC 2.2-5-8\(c\)\(1\)](#).

Taxpayer states the following in its protest letter:

The production process requires the utilization of a Lot Traceability System to track parts and components from the beginning of the process through shipment. The traceability system is required by the customer (...) in order to track PC (production control) lot number originating from frames required to produce specific automobiles. In the case of the VCM Bridge assemblies, the Lot Traceability System is required for vehicle safety reasons in order to identify where specific components, such as rocker arms and shafts purchased from Japan are used. Due to the nature of the product, if a catastrophic failure occurred in the field relating to the assembly, specific autos could be targeted for recall and/or shipments in the pipeline.

Taxpayer is reminded that in applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). The taxpayer claiming exemption has the burden of showing the terms of the exemption statute are met. General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991) aff'd 599 N.E.2d 588 (Ind. 1992) (Internal citations omitted).

While the lot traceability system, installed by Taxpayer at the behest of one of its major customers, may provide convenience to both Taxpayer and its customer(s), it does not qualify for the double-direct manufacturing exemption.

FINDING

Taxpayer's protest is sustained as it relates to the dust hog system and the mist collectors. Taxpayer's protest is respectfully denied as it relates to the lot traceability system.

II. Use Tax - Tax Rate.

DISCUSSION

Taxpayer protests that the Department incorrectly assessed use tax on certain capital assets based on the asset capitalization date rather than the purchase date. In these protested instances, the purchase date was prior to the date in which the sales tax rate increased from six percent to seven percent.

Taxpayer is correct. Use tax is imposed on the use, storage, or consumption of tangible personal property in Indiana when sales tax has not been paid at the point of purchase. IC § 6-2.5-3-2(a). Under IC § 6-2.5-3-3 the use tax is measured by the gross retail income received in a retail unitary transaction and is imposed at the same rates as the state gross retail tax under IC § 6-2.5-2-2. Since "use" is defined, per IC § 6-2.5-3-1(a), as "the exercise of any right or power of ownership over tangible personal property," therefore, unless otherwise indicated, the tangible personal property at issue became the property of Taxpayer upon purchase. Therefore, the use tax rate is the same as the sales tax rate. IC § 6-2.5-3-3. In these protested instances, the purchase date was prior to the date in which the sales tax rate increased from six percent to seven percent; thus the tax rate in this instance should be six percent.

FINDING

Taxpayer's protest is sustained.

III. Tax Administration - Negligence Penalty.

DISCUSSION

The Department issued ten percent negligence penalties for the tax years in question. Taxpayer protests the imposition of the penalties. The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides "if a person... incurs, upon examination by the department, a deficiency that is due to negligence... the person is subject to a penalty."

The Department refers to [45 IAC 15-11-2\(b\)](#), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in [45 IAC 15-11-2\(c\)](#), as follows:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-1](#) if the taxpayer affirmatively

establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

Taxpayer has met its burden of proof to show that the deficiencies they incurred are due to reasonable cause and are therefore not subject to a penalty under IC § 6-8.1-10-2.1(a).

FINDING

Taxpayer's protest of the negligence penalty is sustained.

SUMMARY

Taxpayer is sustained on its protest of the imposition of use tax on the dust hog system and mist collectors, but denied on its protest of the imposition of use tax on the lot traceability system.

Taxpayer is sustained on its protest that the Department's audit applied the incorrect tax rate to the protested capital asset purchases.

Lastly, Taxpayer is sustained on its protest of the imposition of the ten-percent negligence penalty.

A supplemental audit will recalculate Taxpayer's use tax and interest for the tax years based on the above findings.

Posted: 05/25/2011 by Legislative Services Agency

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